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Central Intelligence Agency



Washington, D.C. 20505

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## DIRECTORATE OF INTELLIGENCE

16 November 1984

Israel: The Economy and the National Unity Government

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Summary

The recently concluded wage-price freeze and the disbursal of \$1.2 billion in US economic aid last month provides the national unity government with the opportunity to defer hard decisions on economic reform. Although one of the ostensible advantages of a national unity government was that it would be able to deal decisively with the economy, that has not happened. Divisions within the Likud bloc, which holds most of the economic portfolios, have hamstrung economic policymaking. Israeli officials are looking to Washington to provide the foreign exchange needed to avoid making difficult economic choices.

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The recently concluded wage-price freeze and the disbursal of \$1.2 billion in US economic aid last month gave the national unity government some breathing room. It now faces the task of implementing additional budget cuts, devising institutional reforms, and finding some way to prevent wages and prices from exploding after the freeze ends in early February.

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What Needs to Be Done

Based on the public statements of Israeli officials, it appears that a consensus exists on the broad outlines of economic policy. That consensus includes the wage-price freeze, budget cuts, and no movement toward "dollarization." Officials seem to

This memorandum was prepared [ ] of the Israel/Palestinian Branch, Arab-Israeli Division, Office of Near Eastern and South Asian Analysis, at the request of Howard Teicher of the National Security Council. Information as of 15 November 1984 was used in its preparation. Questions and comments are welcome and should be directed to Chief, Arab-Israeli Division, [ ]

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be in agreement on the need to move workers out of service jobs, particularly in the public-sector, and into export industries. Judging by recent press commentary, some officials also recognize the need for tax reform accompanied by effective enforcement.

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Any serious attempt to solve Israel's economic problems must start with the government budget. We believe cuts of at least \$1 billion are required. Beyond decisions on where the budget should be trimmed, the government must decide on how such cuts will be enforced. Several times during the past two years, budget "cuts" approved by the Cabinet did not materialize. Ministers have become adept at using "unanticipated" price hikes to justify their actual outlays, and no minister has been reprimanded for overspending. Under the Basic Law, Cabinet ministers cannot be removed.

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In conjunction with reduced spending, the government needs to devise a system allowing the Bank of Israel to undertake independent monetary policies. Under present law and custom, the Bank is required to print enough shekels to finance the government's budget deficit. In the past, Bank officials have resorted to selective credit controls, but bankers and companies have devised ways to get around them.

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Additional steps must be taken to lower real wages and reduce the cost-of-living adjustment formula. Real wage gains averaging 7 percent a year since 1976, which resulted in part from the cost-of-living adjustments, have been a major impetus to inflation. Under the terms of the wage-price freeze, the cost-of-living formula will be reduced during the next three months. To maintain real wage reductions over the long term, however, the government must start planning now with leaders of the Histadrut, the powerful trade union organization.

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Measures must be taken to end the system under which wage patterns are based on a series of interrelated agreements. For example, engineers' salaries are directly linked to those of the teachers, and technicians' pay is linked to that of engineers. Such linkages make it extremely difficult to encourage Israelis to enter occupations that are short of workers by increasing salaries for those jobs without creating wage spirals.

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### Obstacles

The dilemma facing Israeli politicians is that the required remedies for the country's economic problems will necessitate violating at least one, and probably both, of the "golden rules" concerning the economy that have been followed for more than a decade:

- High unemployment, traditionally anything above 5 percent, is intolerable.
- Living standards should not be eroded.

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Although one of the ostensible benefits of a national unity government was that it would be able to deal with the economy decisively, that has not happened. The much touted \$1 billion budget cut adopted at the first Cabinet meeting in September turned out to be more like \$500 million; most ministers loudly objected to any trims in their budgets, and most of the "cuts" agreed to are actually additional fees for government services. The negotiations over the wage-price freeze went on for nearly two months, and agreement was reached only after Prime Minister Peres took personal charge of the talks. [REDACTED]

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Divisions within the Likud bloc, which holds most of the economic portfolios, have hampered economic policymaking. Sniping by Herut ministers at Finance Minister Modai, who also is chairman of the Liberal Party, has led to Liberal threats to leave Likud and join Labor. Deputy Prime Minister and Minister for Housing and Construction Levi has been extremely critical of proposals for economic austerity because they are likely to hurt workers. Levi's "populist" appeals to Israeli workers probably are intended to position him to challenge Labor's hold on the Histadrut secretary general job during elections next spring. He also is maneuvering for advantage in the internal Herut power struggle. Minister of Trade and Commerce Sharon, a Levi rival, is also trying to gain worker support by mounting a campaign against "exorbitant" price hikes. [REDACTED]

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Overshadowing all of the Cabinet deliberations on the economy is the specter of a new national election. We believe the national unity government is unlikely to serve out its full fifty-month term and could collapse within a year--a view widely shared in Israel. Because of the possibility of an early election, neither of the major parties wants to be blamed by the voters for unpopular economic policies. In our view, each will try to put the onus on the other for any austerity policies that are actually implemented, but, because the politicians are unsure of their success with that strategy, they will be reluctant to adopt the necessary stringent measures unless the situation leaves them no other choice. [REDACTED]

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Histadrut leaders acknowledge the need for emergency measures to deal with the economy, but are coming under growing pressure from young union militants demanding more aggressive protection of worker interests. Histadrut Secretary General Kessar faces a reelection campaign early next year and, as a result, will be reluctant to support government proposals that could spark major Histadrut divisions. According to the US Embassy, Histadrut leaders recognize that the wage-price freeze could rebound against Kessar if prices continue to escalate while wages are frozen. [REDACTED]

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#### Outlook

Israeli officials undoubtedly hope that the wage-price freeze will convince the United States that they are dealing

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seriously with the country's economic crisis. They probably will argue that the freeze warrants supplemental economic aid for FY 1985 when Congress reconvenes in January. [REDACTED]

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We believe that Israel's foreign exchange situation will determine how hard officials put on the brakes. So far, they appear to believe that if austerity measures are applied for a short period of time, the problem will be solved and they can go back to business as usual. The national unity government has yet to devise a strategy that goes beyond the expiration of the wage-price freeze, and we expect officials will resort to stopgap measures in an effort to muddle through. [REDACTED]

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Finance Minister Modai will probably propose more budget cuts, most likely in the context of the budget for FY 1985 which begins on 1 April. Disciplining Cabinet ministers for exceeding budget ceilings, however, will be extremely difficult. According to some press reports, the defense budget will be exempted from any cuts, which would require the burden to fall on social welfare spending. [REDACTED]

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A comprehensive agreement on the cost-of-living formula and real wages is unlikely. We believe that Histadrut officials, particularly with the trade union election approaching, will be under tremendous pressure to recoup real wage losses incurred during the freeze, estimated by the US Embassy at 20 percent. If workers believe that merchants were able to violate the freeze by raising their prices, Kessar will have little choice but to demand a large wage increase in February. [REDACTED]

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Institutional reforms, such as the tax system or monetary policy, will probably die in the heat of political squabbling. Powerful vested interests, such as bankers, can probably play off various factions within the national unity government against each other. [REDACTED]

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#### Implications for the United States

Israeli officials are looking to Washington to provide the foreign exchange needed to avoid making difficult economic choices. They are willing to discuss their economy with the United States because they know they need additional aid, but domestic considerations will be the major factor guiding their policy choices. They will contend that US officials in the past have told them that the only criterion determining the level of aid will be the condition of the Israeli economy. They will argue that, since the economy is in such sad shape, they are entitled to the large sums of money that they have requested. They will resist any attempt to condition additional aid on either the economic policies they pursue or political considerations, such as movement on the peace process. Israeli Government officials are already sensitive to charges in the Israeli press that the United States is dictating economic policy to Israel. [REDACTED]

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NESA M#84-10301

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